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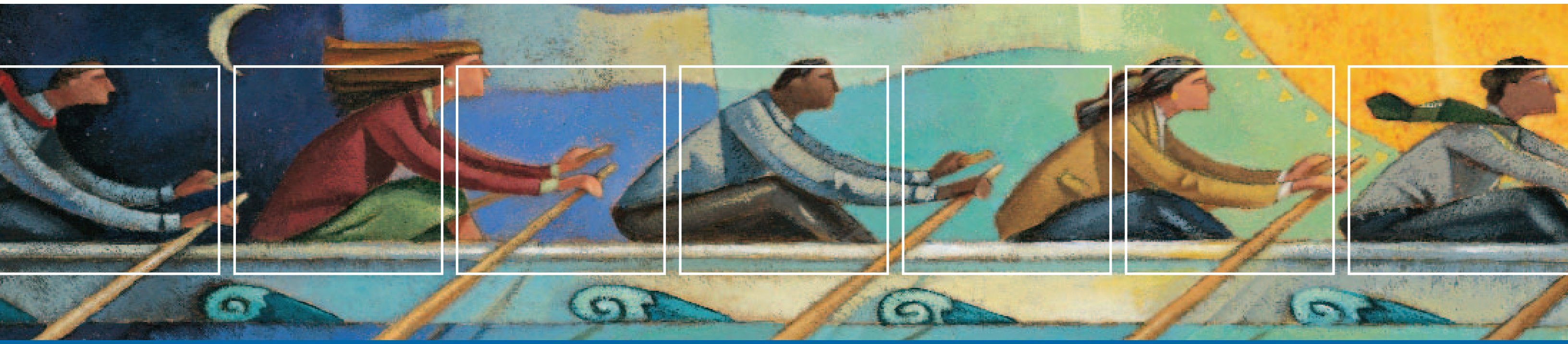
on Retirement



Exploding the Myth That Employees Always Prefer DC Plans

May 2004

New information about employee preferences

Many employers have decided to offer defined contribution (DC) retirement plans because they say their employees prefer them. But new evidence indicates that this stated preference is a myth. In fact, depending on the plan structure, employees at different ages and life-cycle stages may prefer defined benefit (DB) plans.

Surprising facts about employee preferences and employee understanding of retirement financing emerge from two recent studies: the Retirement Plan Preference Survey, a 2003 public opinion survey sponsored jointly by the Society of Actuaries and the American Academy of Actuaries, and the 2003 Process and Risks of Retirement Survey, sponsored by the Society of Actuaries.

Consequently, plan sponsors would be well advised to review the recent research that addresses worker preference, along with data about the elections employees actually make, before considering alternative programs.

Preferences about plan types

Myth	Employees prefer DC plans.
Fact	When given a choice between retirement plans, employees often choose to stay with the DB plan.

It is widely believed that employees generally prefer DC plans, particularly 401(k) plans, when given a choice of retirement plan types. Yet when traditional plans have been converted to DC plans and employees are given a choice between a DB or a DC plan, employees, including younger ones, often opt for the DB plan. Why? One possible explanation is that they tend to favor what they have. Another may be that upon learning the pros and cons of each plan, they prefer that the employer make the investment decisions and bear the risk.

The controversy over cash balance plans and the desire to enhance the perceived value of retirement programs has prompted employers to offer employees more retirement plan choices. Usually, it's between a traditional DB plan and either a new hybrid within the DB plan (usually a cash balance formula) or an enhanced DC plan. In our view, a substantial portion of the workforce frequently views traditional DB programs as competitive with or even superior to hybrid or DC plan designs – especially if employers clearly communicate the DB plan's benefits.

Consider the following examples:

- A large electronics employer offered its workers a choice between a traditional final average pay plan and a DC alternative (an enhanced match plus an annual contribution that was a fixed percentage of pay). To the employer's surprise, two-thirds of its employees, including a substantial portion of its younger employees, chose to remain under the traditional formula and forego the DC alternative.
- A large health care employer offers employees an annual option to forego additional benefit accruals in their DB plan in exchange for a substantially enhanced match on their 401(k) contributions that vest immediately. In the first year of the program, 80 percent of the employees either chose or defaulted into the traditional DB program, despite the enhanced 401(k) matching contributions.

Much of the perceived indifference that employees feel towards their DB pensions is caused by a communications gap – when this gap is closed, the indifference evaporates.

The bottom line

Plan sponsors should offer retirement plans that meet their human resource and financial needs, and teach employees how to plan for retirement more effectively. We recommend a combination of DB and DC plans. Companies that want to appeal to as many employees as possible may consider offering hybrid plans, which integrate DB and DC features, or supplemental DC plans that enhance but do not replace DB plans.

Considerations in payout option decision

Myth Employees prefer lump sum distributions.

Fact Both workers and retirees say that lifetime income is very important to them.

Consider this survey question and its responses:

When deciding among retirement plan payout options, how important is each of the following considerations?	Very important to	
	Workers	Retirees
Having lifetime income	69%	86%
Not outliving my money	69%	77%
Keeping up with inflation	65%	75%
Controlling savings	61%	54%
Protecting against market downturns	53%	55%
Protecting against loss of value in the event of early death	49%	44%
Accessing money in an emergency	38%	30%
Leaving an inheritance	31%	19%

According to the 2003 Retirement Plan Preference Survey (mentioned earlier), both active and retired employees indicated a strong preference for lifetime income. This preference, together with the other responses, puzzled the researchers at first. In practice, they saw retirees choose lump sums most often when offered a choice in their DB plans. After some additional consideration, the researchers surmised that retirees might be considering regular payments or withdrawals from a mutual fund or savings account as "lifetime" income, even though they are not. In other words, retirees don't appear to distinguish between guaranteed and non-guaranteed payouts. In fact, retirees drawing the same amount that a life annuity would provide, earning the same return that was used in determining the life annuity, have over a 50 percent chance of outliving their income.

The bottom line

Annuity options are important to include regardless of plan type. Where lump sums are offered, participants need to understand the possibility of outliving their income.

Workers say they want lifetime income but choose lump sum distributions. To understand this discrepancy, more research is needed. But effective communication from plan sponsors about payout options – and particularly about guarantees – may help employees make more informed choices. By explaining the details of payout options, employers can help employees identify needs and evaluate what options would be best to provide for those needs.

Tradeoffs between risk and control

Myth	Employees prefer to control their own investments and accept the associated risk.
Fact	Disappointing returns and losses in 401(k) plans force people to postpone retirement. A plan with a guaranteed benefit would allow people to retire as planned.

According to the 2003 Quicken Fiscal Literacy Survey, economic conditions forced 2.3 million households to postpone retirement, up from 1.9 million a year earlier – a 21 percent increase *(See below)*.

Delaying retirement is an obvious problem for individual retirees. But it may also be a problem for the employer who was counting on a regular pattern of retirement to make room for new hires and promote strong performers.

The bottom line

One of the chief purposes of a retirement plan is to provide income security. While a DC plan has the potential to generate a larger amount of wealth than a DB plan, much depends on the employee, including his or her investment savvy, contribution level, and spend-down scenario. Research shows that retiree and near-retiree reaction to market decline has forced many to postpone retirement or resume work. Depending on their employees' stage of life and career objectives, employers that offer a combination of both DB and DC plans may provide the best retirement strategy.

Poor investment returns and low expectations are delaying retirement and sending retirees back to work

In the 2003 Retirement Confidence Survey*, one-fourth of workers age 45 and older indicated that, within the past year, they have decided to postpone their retirement, citing the following principal reasons:

- having to work longer to make up for losses in the stock market,
- wanting to make sure they are financially secure,
- the increasing eligibility age for Social Security, and
- a higher-than-expected cost of living.

In late 2002, the American Association of Retired Persons (AARP) conducted a survey of 50- to 70-year-old investors to determine how stock market declines had affected their retirement plans and behaviors. They found that

- Of the respondents who own stock, 77 percent said that they had lost money in the last two years.
- Of those who have lost money in stocks and not yet retired, 21 percent postponed retirement because of the loss.
- Among investors who have lost money, 43 percent expect to be less comfortable in retirement due to their losses and 20 percent think that they will have difficulty paying for health care and prescription drugs during retirement.
- Of investors who lost money in stocks and had already retired, 10 percent either had returned to work or were still working because of their loss. (Note that it is common for people to say they are retired when they are actually still working. They may have "officially" left a long-term employment situation or career but are working in an alternative profession or part-time to augment income during retirement.)

Discussions with plan sponsors indicate that employees are reluctant to retire both because of losses in their 401(k) accounts and because of fear about future performance. Whereas five years ago, people expected the unusual performance of the 1990s to continue, now they are much more skeptical.

*Sponsored by the Employee Benefit Research Institute and Mathew Greenwald & Associates.

Is this research surprising?

Experience adds insights

Mercer has acquired insight and understanding in helping employers and other plan sponsors with their retirement benefit offerings. Some findings are consistent with or complement more recent analysis. We have long understood that:

- What people say and how they act are sometimes different. But by providing better communication, we can close this gap and bring people's intentions more in line with their actions.
- When private sector employees are given a choice, older employees and those with longer service want to stay with their traditional DB plans.
- Public sector employees, when given a choice of a DC or a traditional DB plan, often choose the DB plan.
- Rewards of expected high investment returns look great, but they are not guaranteed and may entail significant risk, which affects when employees can afford to retire.

Publicly available studies have consistently shown that workers misunderstand investment risk, investment options, and the impact of variability. Many employees erroneously think that money market mutual funds include stocks or that a diversified stock portfolio is riskier than company stock.

In summary

Traversing the future retirement landscape will be challenging because of the decline in the prevalence of DB plans, low savings rates in the United States, increasing retiree longevity, and the failure of many employees to plan for retirement effectively.

As research has shown, there is widespread ignorance, general confusion, and startling misperceptions about retirement planning. And any system that shifts too much of the financial burden onto employees is likely to leave some people without adequate resources.

Employers can adopt several different strategies to enhance their employees' retirement futures, including:

- Designing plans that use employer dollars most effectively and to add the most value, ensuring that plans enable employees to retire in accordance with company policy.
- Designing plans that make it easier for employees to save. For example, using a modest DB plan as a base and adding voluntary savings. Or including automatic enrollment, default investment options, and a mechanism to direct pay increases automatically into the DC plan to minimize decision making and maximize retirement savings.
- Augmenting education with fact-based research so employees can understand the implications of their choices.
- Maintaining a meaningful level of employer contributions to retirement programs, whether DB or DC.
- Managing plan administrative expenses.

DB or DC – a plan sponsor's choice

The best choice depends on where in the life cycle most of your employees are and the specific plan designs. For younger employees who change employment often, DC plans (or cash balance DB plans) are best because they're portable. For employees with long careers at one firm, traditional DB plans are usually better because they provide significantly greater benefits. Both types of plans can be designed to meet a specific cost level, but the DB plan is more risky to the plan sponsor. If plan alternatives are cost neutral, long-service employees will get much better benefits from the DB plan. So a plan sponsor should consider its objectives carefully when allocating available dollars among participants. Often, objectives are best met with a combination of plans.

Editorial Policy

The *Mercer Perspective on Retirement* series contains articles written by senior Mercer consultants that reflect their unique insights and observations on a variety of important topics affecting retirement and benefit programs. The views expressed do not necessarily reflect the views and policies of Mercer Human Resource Consulting, Inc.

Author

Anna M. Rappaport, FSA, is a principal with Mercer Human Resource Consulting. She is concerned about human resources strategy and financial security in an aging society, and about strategies to help businesses work most effectively in light of the changing demographics. She is a past president of the Society of Actuaries, serves on several boards, and is a frequent writer and speaker.

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For further information, contact your local Mercer Human Resource Consulting office or the firm's headquarters:

1166 Avenue of the Americas
New York, NY 10036
212 345 7000

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